IBM

1133 Westchester Avenue
White Plains, NY 10604

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The Honorable Jon Porter (R-NV)
Chairman
House Government Reform Subcommittee on the Federal Workforce and Agency Organization
US House of Representatives
B-373A Rayburn House Office Building
Washington, DC 20515

Chairman Porter:

IBM is pleased to respond to the Committee's interest in our perspective on REITs. We debated the question of adding REITs to our 401(k) for several years before proceeding with them two years ago.

The IBM Savings Plan is the largest 401(k), with $25 billion in assets, a quarter-million participants, and an average balance of $100,000. We are focused on keeping costs very low, and while our Plan costs are higher than TSP's because of our smaller size, our Plan is run at an all-in cost of below 0.15%, extremely low by any other standard.

Our Plan's first tier offers four "life strategy" funds. These are balanced (multi-asset class) funds, which are blended at four different risk levels from the six broad market, or "core", index funds in our second tier. These six funds are US bonds, inflation-protected bonds, stable value (bonds), US stocks, nonUS stocks, and REITs. REITs were added as the sixth and last core fund for use in blending the life strategy funds two years ago, and offered as a stand-alone fund a year ago.

The third tier is 13 narrower funds for participants that want more choice, e.g. small US growth stocks, unhedged European stocks, etc. A few months ago we added a small mutual fund window, for a fee, for participants who feel the need for even more choice.

<u>Benefits of REITs to the IBM Savings Plan</u>:

- REITs represent an investment window into the multi-trillion dollar commercial real estate market that is mostly privately owned and thus not well-represented in broad stock market indices.
- Daily liquidity (required for daily-traded 401(k) environment)
- REIT prices move more smoothly than most real estate investments which are often priced by appraisal.
- Less expensive than direct investment in private real estate
- Returns and volatility have been slightly superior to the S&P over the past 30+ years. Past performance is of course no indication of the future, but we think it likely that REITs will continue to offer competitive returns and volatility in the long-term.
- Good diversification vs. other investments, even for homeowners (more on this, next page). Long-term, REITs have diversified well against US stocks, nonUS stocks, and bonds. As REITs began to mature about a decade ago with a significant increase in their total market capitalization, their returns became less and less correlated with general equity markets. REITs are increasingly viewed as a separate asset class, rather than as just a small part of the overall stock market.
- While recent volatility has been higher, long-term REIT volatility is expected to be lower than that of the broad equity market, reflecting the "anchoring" effect of REIT dividends in total return. At 5%, REIT dividends are currently 2½ times higher than US stock dividends, and they have grown at a faster rate and in a more stable fashion as well.
- From a Plan design perspective, we also consider tax efficiency. REIT dividends are subject to ordinary income taxes, which makes them a good investment for defined contribution plans where taxes are deferred for many years. It is not just "asset <u>allo</u>cation" – it is "asset <u>lo</u>cation". Our participants can invest their tax-deferred money in investments like REITs with higher yields and defer taxes, while investing after-tax money in lower-yielding investments like US stocks, reaping the benefits of lower capital gains taxes.

Arguments Against REITs and IBM's Responses:

- "US stock offerings already include REITs": The S&P does have a very small weight in REITs and real estate development (0.6%), but this represents a very small part of total commercial real estate, and this, as well as the power of expected REIT diversification, led us to conclude that this wasn't a show-stopper.
- "A large proportion of our participants already have a large part of their personal net worth in their own homes and do not need additional real estate investment opportunities": The historical correlation between REITs and home prices is surprisingly low, and we took the view that REIT return, volatility, correlation, and liquidity arguments outweighed this concern.
- "Too many offerings confuse participants": This was one reason we waited until last year to offer REITs as a stand-alone offering. We ultimately assessed the risk as worthwhile, and added REITs as a building block in our life strategy fund construction and as one of our six "core" offerings.
- A current concern might be that "REIT returns were very high in 2003 and 2004", and higher valuations could of course mean lower future yields. Furthermore, bond yields have crept higher, reducing REITs' competitive yield advantage over bonds. Real estate fundamentals do seem to be improving, with vacancy rates edging lower and pricing firming, but we stay away from making timing calls. The decision to add REITs was a long-term decision, and we encourage our participants to make their decisions on a long-term basis as well.

Implementation

Like TSP, most of the IBM 401(k) offerings are extremely low cost index funds, but we did debate the virtues of active versus passive for REITs. It was a tough decision, because unlike most other asset classes, active REIT managers have generally outperformed the market. But manager excess returns can be volatile and costs are substantially higher, so chose an indexed approach.

We chose the Morgan Stanley REIT index as our benchmark. While in principle we would have preferred the broader NAREIT index, it includes a lot of illiquid REITs which is of particular importance given 401(k) daily trading requirements. It also appeared that portfolio tracking error would have been substantially higher using the NAREIT index as a benchmark.

Our manager selection focused on fees, transaction costs, and tracking error. A key challenge is that REIT indexes assume immediate reinvestment of REIT dividends, which cannot actually be invested until received. With a 5% dividend rate, this needs careful consideration.

We initially offered REITs as components of our four balanced funds, which represent almost $4 billion of our Plan's assets, so this was a major step. While REITs are quite well suited for lower risk balanced funds, we found that they had a role in higher risk ones as well. A year ago we added REITs as a stand-alone core fund.

Conclusion:

We are committed to REITs as a core asset class for defined contribution plans for all the reasons described. Their return, volatility, diversification, dividend yield, and taxation characteristics make the case, and we have seen increased interest in adding them to other companies' defined contribution plans, for the same reasons.

We trust the foregoing discussion is useful to you and wish you well in your deliberations.

Sincerely,

Jay Vivian

R. L. Vivian
Managing Director